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# Legislative and Regulatory Proposals and Explanatory Notes Relating to Income Tax

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## Impaired Loans

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Published by  
The Honourable Paul Martin, P.C., M.P.  
Minister of Finance

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Available from the Finance Canada Distribution Centre  
300 Laurier Avenue West, Ottawa K1A 0G5  
Tel: (613) 995-2855  
Fax: (613) 996-0518

Cette publication est également disponible en français.

Cat No.: F2-121/1997E


ISBN-0-660-17248-8



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# Legislative and Regulatory Proposals

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DRAFT INCOME TAX LEGISLATION AND REGULATIONS  
RELATING TO IMPAIRED LOANS

(a) Income Tax Act

**1. (1) Paragraph 12(1)(c) of the Act is replaced by the following:**

**Interest**

(c) subject to subsections (3) and (5), any amount received or receivable by the taxpayer in the year (depending on the method regularly followed by the taxpayer in computing the taxpayer's income) as, on account of, in lieu of payment of or in satisfaction of, interest to the extent that the interest was not included in computing the taxpayer's income for a preceding taxation year; 5

**(2) Subsections 12(3) and (4) of the Act are replaced by the following:** 10

**Interest income**

(3) Subject to subsection (5), in computing the income for a taxation year of a corporation, partnership, unit trust or any trust of which a corporation or a partnership is a beneficiary, there shall be included any interest on a debt obligation (other than interest in respect of an income bond, an income debenture, a small business bond, a small business development bond, a net income stabilization account or an indexed debt obligation) that accrues to it to the end of the year, or becomes receivable or is received by it before the end of the year, to the extent that the interest was not included in computing its income for a preceding taxation year. 15 20

**Interest from  
investment contract**

(4) Subject to subsection (5), where in a taxation year a taxpayer (other than a taxpayer to whom subsection (3) applies) holds an interest in an investment contract on any anniversary day of the contract, there shall be included in computing the taxpayer's income for the year the interest that accrued to the taxpayer to the end of that day with respect to the investment contract, to the extent that the interest was not otherwise included in computing the taxpayer's income for the year or any preceding taxation year. 25 30

## Impaired debt obligations

(5) Paragraph (1)(c) and subsections (3) and (4) do not apply to a taxpayer in respect of a debt obligation for the part of a taxation year throughout which the obligation is impaired where an amount in respect of the obligation is deductible because of subparagraph 20(1)(l)(ii) in computing the taxpayer's income for the year. 5

### (3) Subsections (1) and (2) apply

(a) to taxation years that end after September 1997; and

(b) to taxation years that end after 1995 and before October 1997 10  
where the taxpayer files an election in accordance with paragraph 3(5)(b).

2. (1) The portion of subsection 16(6) of the Act before paragraph (a) is replaced by the following:

## Indexed debt obligations

15

(6) Subject to subsection (7) and for the purposes of this Act, where at any time in a taxpayer's taxation year

(2) Section 16 of the Act is amended by adding the following after subsection (6): 20

## Impaired indexed debt obligations

(7) Paragraph (6)(a) does not apply to a taxpayer in respect of an indexed debt obligation for the part of a taxation year throughout which the obligation is impaired where an amount in respect of the obligation 25  
is deductible because of subparagraph 20(1)(l)(ii) in computing the taxpayer's income for the year.

### (3) Subsections (1) and (2) apply

(a) to taxation years that end after September 1997; and

(b) to taxation years that end after 1995 and before October 1997 30  
where the taxpayer files an election in accordance with paragraph 3(5)(b).



### 3. (1) Paragraph 20(1)(I) of the Act is replaced by the following:

#### Doubtful or impaired debts

(I) a reserve determined as the total of

(i) a reasonable amount in respect of doubtful debts (other than a debt to which subparagraph (ii) applies) that have been included in computing the taxpayer's income for the year or a preceding taxation year, and 5

(ii) where the taxpayer is a financial institution (as defined in subsection 142.2(1)) in the year or a taxpayer whose ordinary business includes the lending of money, an amount in respect of properties (other than mark-to-market properties, as defined in that subsection) that are 10

(A) impaired loans or lending assets that are specified debt obligations (as defined in that subsection) of the taxpayer, or 15

(B) impaired loans or lending assets that were made or acquired by the taxpayer in the ordinary course of the taxpayer's business of insurance or the lending of money

equal to the total of

(C) such percentage (not exceeding 100%) as the taxpayer claims of the prescribed reserve amount for the taxpayer for the year, and 20

(D) in respect of loans, lending assets or specified debt obligations that are impaired and for which an amount is not deductible for the year because of clause (C) (each of which in this clause is referred to as a "loan"), the taxpayer's specified percentage for the year of the lesser of 25

(I) the total of all amounts each of which is a reasonable amount as a reserve (other than any portion of which is in respect of a sectoral reserve) for a loan in respect of the amortized cost of the loan to the taxpayer at the end of the year, and 30

(II) the amount determined by the formula

$$0.9M - N$$

where

M is the amount that is the taxpayer's reserve or allowance for impairment (other than any portion of the amount that is in respect of a sectoral reserve) for all loans that is determined for the year in accordance with generally accepted accounting principles, and

5

N is the total of all amounts each of which is the specified reserve adjustment for a loan (other than an income bond, an income debenture, a small business bond or small business development bond) for the year or a preceding taxation year;

10

**(2) Subparagraph 20(1)(I.1)(ii) of the Act is replaced by the following:**

(ii) 90% of the reserve for credit risk losses of the taxpayer expected to arise after the end of the year under or in respect of those instruments or commitments determined for the year in accordance with generally accepted accounting principles,

15

**(3) Section 20 of the Act is amended by adding the following after subsection (2.2):**

#### **Sectoral reserve**

20

(2.3) For the purpose of clause (1)(I)(ii)(D), a sectoral reserve is a reserve or an allowance for impairment for a loan that is determined on a sector-by-sector basis (including a geographic sector, an industrial sector or a sector of any other nature) and not on a property-by-property basis.

25

#### **Specified Percentage**

(2.4) For the purpose of clause (1)(I)(ii)(D), a taxpayer's specified percentage for a taxation year is

30

(a) where the taxpayer has a prescribed reserve amount for the year, the percentage that is the percentage of the prescribed reserve amount of the taxpayer for the year claimed by the taxpayer under clause (1)(I)(ii)(C) for the year, and

35

(b) in any other case, 100%.

**(4) Section 20 of the Act is amended by adding the following after subsection (29):**

**Specified reserve  
adjustment**

(30) For the purpose of the description of N in 5  
subclause (1)(l)(ii)(D)(II), the specified reserve adjustment for a loan of  
a taxpayer for a taxation year is the amount determined by the formula

$$0.1(A \times B \times C/365)$$

where

- A is the carrying amount of the impaired loan that is used or would be  
used in determining the interest income on the loan for the year in  
accordance with generally accepted accounting principles; 15
- B is the effective interest rate on the loan for the year determined  
in accordance with generally accepted accounting principles; and
- C is the number of days in the year on which the loan is impaired. 20

**(5) Subsections (1) to (4) apply**

**(a) to taxation years that end after September 1997; and**

**(b) to taxation years that end after 1995 and before October 1997  
where the taxpayer elects in writing to have subsection (1) apply  
to the year and files the election with the Minister of National 25  
Revenue before the end of the third month after the month in  
which this Act is assented to.**

**4. (1) Subsection 79.1(8) of the Act is replaced by the following:**

**Claims for debts**

(8) Where a property is seized at any time in a taxation year by a 30  
creditor in respect of a debt, no amount in respect of the debt

(a) is deductible in computing the creditor's income for the year or  
a subsequent taxation year as a bad, doubtful or impaired debt; or

(b) shall be included after that time in computing, for the purposes  
of this Act, any balance of undeducted outlays, expenses or other 35  
amounts of the creditor as a bad, doubtful or impaired debt.

**(2) Subsection (1) applies**

(a) to taxation years that end after September 1997; and

(b) to taxation years that end after 1995 and before October 1997 where the taxpayer files an election in accordance with paragraph 3(5)(b).

5. (1) That portion of subsection 142.3(1) of the Act before paragraph (a) is replaced by the following:

Amounts to be  
included and  
deducted

142.3 (1) Subject to subsections (3) and (4), where a taxpayer that is, in a taxation year, a financial institution holds a specified debt obligation at any time in the year,

(2) Section 142.3 of the Act is amended by adding the following after subsection (3):

Impaired specified  
debt obligations

15

(4) Subsection (1) does not apply to a taxpayer in respect of a specified debt obligation for the part of a taxation year throughout which the obligation is impaired where an amount in respect of the obligation is deductible because of subparagraph 20(1)(l)(ii) in computing the taxpayer's income for the year.

(3) Subsections (1) and (2) apply

(a) to taxation years that end after September 1997; and

(b) to taxation years that end after 1995 and before October 1997 where the taxpayer files an election in accordance with paragraph 3(5)(b).

6. (1) The definition "lending asset" in subsection 248(1) of the Act is replaced by the following:

"lending asset"  
« titre d'emprunt »

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"lending asset" means a bond, debenture, mortgage, note, agreement of sale or any other indebtedness or a prescribed share, but does not include a prescribed property;

(2) Subsection (1) applies



(a) to taxation years that end after September 1997; and

(b) to taxation years that end after 1995 and before October 1997 where the taxpayer files an election in accordance with paragraph 3(5)(b).

(b) Income Tax Regulations

5

1. (1) That portion of paragraph 6209(b) of the *Income Tax Regulations* before subparagraph (i) is replaced by the following:

(b) a property is a prescribed property for a taxation year where

(2) Paragraph 6209(b) of the Regulations is amended by striking out the word "or" at the end of subparagraph (i), by adding the word "or" at the end of subparagraph (ii) and by adding the following after subparagraph (ii):

(iii) the property is a direct financing lease, or is any other financing arrangement, of a taxpayer that is reported as a loan in the taxpayer's financial statement for the year prepared in accordance with generally accepted accounting principles and an amount is deductible under paragraph 20(1)(a) of the Act in respect of the property that is the subject of the lease or arrangement in computing the taxpayer's income for the year.

(3) Subsections (1) and (2) apply

20

(a) to taxation years that end after September 1997; and

(b) to taxation years that end after 1995 and before October 1997 where the taxpayer elects under paragraph 3(5)(b) of the attached draft amendments to the *Income Tax Act*.

2. (1) That portion of section 8000 of the Regulations before paragraph (a) is replaced by the following:

**8000.** For the purpose of clause 20(1)(l)(ii)(C) of the Act, the prescribed reserve amount for a taxation year means the aggregate of

(2) Section 8000(a) of the Regulations is amended by striking out the word "and" at the end of paragraph (a) and by adding the following after paragraph (a):

(a.1) where the taxpayer is a bank, the positive or negative amount that would be determined under the formula in subparagraph (a)(ii) in respect of the specified loans owned by the taxpayer at the end of the year if that subparagraph applied to those loans, and

35



(3) Paragraph 8000(b) of the Regulations is repealed.

(4) Subsections (1) and (3) apply

(a) to taxation years that end after September 1997; and

(b) to taxation years that end after 1995 and before October 1997 where the taxpayer elects under paragraph 3(5)(b) of the attached draft amendments to the *Income Tax Act*. 5

(5) Subsection (2) applies

(a) to the 1997 and subsequent taxation years; and

(b) to taxation years that end after 1991 and before 1997 where the taxpayer elects in writing to have paragraph 8000(a.1) of the Regulations, as enacted by that subsection, apply to those years and files the election with the Minister of National Revenue before the end of the third month after the month in which that paragraph is published in the *Canada Gazette* Part II. 10

3. (1) Section 8001 of the Regulations is repealed. 15

(2) Subsection (1) applies

(a) to taxation years that end after September 1997; and

(b) to taxation years that end after 1995 and before October 1997 where the taxpayer elects under paragraph 3(5)(b) of the attached draft amendments to the *Income Tax Act*. 20

4. (1) Section 8002 of the Regulations is amended by striking out the word "and" at the end of paragraph (a) and by replacing paragraph (b) with the following:

(b) where

(i) a taxpayer realizes a loss from the disposition of a loan or lending asset described in subparagraph 8000(a)(ii) or a specified loan described in paragraph 8000(a.1) (in this paragraph referred to as the "former loan") for consideration that included another loan or lending asset that was a loan or lending asset described in that subparagraph or that paragraph (in this paragraph referred to as the "new loan"), and 25 30

(ii) in the case of a former loan that is not a specified loan, the loss is included in computing the taxpayer's provisionable assets as reported for the year to the relevant authority, in accordance

with the guidelines established by the relevant authority, for the purpose of determining the taxpayer's general provisions or specific provisions in respect of exposures to designated countries,

the principal amount of the new loan outstanding at the time it was acquired by the taxpayer is deemed to be equal to the principal amount of the former loan outstanding immediately before that time; and

(c) where at the end of a particular taxation year a taxpayer owns a specified loan that, at the end of the preceding taxation year, was described in an inventory of the taxpayer, the amortized cost of the specified loan to the taxpayer at the end of the particular year is its value determined under section 10 of the Act at the end of the preceding year for the purpose of computing the taxpayer's income for the preceding year.

## **(2) Subsection (1) applies**

**(a) to the 1997 and subsequent taxation years; and**

**(b) to taxation years that end after 1991 and before 1997 where the taxpayer elects in writing to have paragraph 8000(a.1) of the Regulations, as enacted by subsection 2(2), apply to those years and files the election with the Minister of National Revenue before the end of the third month after the month in which that paragraph is published in the *Canada Gazette* Part II.**

**5. (1) Section 8004 of the Regulations is repealed.**

## **(2) Subsection (1) applies**

**(a) to taxation years that end after September 1997; and**

**(b) to taxation years that end after 1995 and before October 1997 where the taxpayer elects under paragraph 3(5)(b) of the attached draft amendments to the *Income Tax Act*.**

**6. (1) Section 8006 of the Regulations is amended by adding the following in alphabetical order:**

"specified loan"

"specified loan" means

(a) a United Mexican States Collateralized Par Bond due 2019, or

(b) a United Mexican States Collateralized Discount Bond due 2019;

**(2) Subsection (1) applies**

**(a) to the 1997 and subsequent taxation years; and**

**(b) to taxation years that end after 1991 and before 1997 where the taxpayer elects in writing to have paragraph 8000(a.1) of the Regulations, as enacted by subsection 2(2), apply to those years and files the election with the Minister of National Revenue before the end of the third month after the month in which that paragraph is published in the *Canada Gazette* Part II.** 5

**7. (1) Part LXXX of the Regulations is amended by adding the following section after section 8006:** 10

**8007.** Paragraph 8000(b) does not apply in respect of a specified loan of a bank.

**(2) Subsection (1) applies to taxation years that end after 1991 and before October 1997 where the taxpayer elects in writing to have paragraph 8000(a.1) of the said Regulations, as enacted by subsection 2(2), apply to those years and files the election with the Minister of National Revenue before the end of the third month after the month in which that paragraph is published in the *Canada Gazette* Part II.** 15 20

**8. (1) Part XC of the Regulations is amended by adding the following after section 9003:**

**9004.** For the purpose of the definition "specified debt obligation" in subsection 142.2(1) of the Act, a property is a prescribed property throughout a taxation year where the property is a direct financing lease, or is any other financing arrangement, of a taxpayer that is reported as a loan in the taxpayer's financial statement for the year prepared in accordance with generally accepted accounting principles and an amount is deductible under paragraph 20(1)(a) of the Act in respect of the property that is the subject of the lease or arrangement in computing the taxpayer's income for the year. 25 30

**(2) Subsection (1) applies**

**(a) to taxation years that end after September 1997; and**

**(b) to taxation years that end after 1995 and before October 1997 where the taxpayer elects under subparagraph 3(5)(b) of the attached draft amendments to the *Income Tax Act*.** 35

**9. (1) Subsection 9103(2) of the Regulations is repealed.**

**(2) Subsection (1) applies**

**(a) to taxation years that end after September 1997; and**

**(b) to taxation years that end after 1995 and before October 1997  
where the taxpayer elects under subparagraph 3(5)(b) of the 5  
attached draft amendments to the *Income Tax Act*.**





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## **Explanatory Notes**

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## Explanatory Notes

In 1995, the Canadian Institute of Chartered Accountants established new accounting standards for the recognition, measurement, presentation and disclosure of impaired loans, restructured loans and foreclosed assets. These new rules were adopted by the Office of the Superintendent of Financial Institutions in respect of their application to federally regulated financial institutions. In the continuing effort to simplify and streamline the income tax provisions, the accompanying proposed legislative amendments generally adopt the new accounting standards dealing with the recognition and measurement of impaired loans for the purposes of the *Income Tax Act*.

Under the current income tax provisions, a taxpayer whose business includes the lending of money must include in income for a taxation year any interest that has accrued in the year in respect of a loan, lending asset or specified debt obligation (the "loan") whether or not the loan is fully collectible. The taxpayer may deduct an amount as a reserve in respect of that accrued interest to the extent that its collection is doubtful. The taxpayer may also deduct a reserve in respect of the principal amount of a loan where the collection of the principal amount is doubtful. In addition, the taxpayer may deduct an amount in respect of all, or a part, of a debt that has been included in the taxpayer's income and that is established by the taxpayer to be bad, or of a loan of the taxpayer if the loan is considered to be uncollectible.

In recognition of the new accounting rules for impaired loans, the income tax provisions dealing with interest recognition will be amended so that a taxpayer will not include in income in a taxation year interest that accrues on an impaired loan. As well, a taxpayer that is a financial institution or whose ordinary business includes the lending of money will be allowed to deduct a reserve in a taxation year in respect of a loan that is considered to be impaired under the new accounting standards. In respect of a particular taxation year, the accounting reserve will continue to be reduced by the 10% prescribed recovery rate for the year and that amount will in turn be reduced by the new "specified reserve adjustment" for the year and any preceding taxation years. The "specified reserve adjustment" is defined in proposed subsection 20(30) of the *Income Tax Act* and is 10% of the interest income determined in respect of an impaired loan for a taxation year. The specified reserve adjustment is determined in respect of each impaired loan of the taxpayer. These proposed income tax changes are effective for taxation years that end after September 1997, and also for taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the new reserve provisions apply to those earlier years. The taxpayer must file the election with Revenue Canada by the end of the third month

after the month in which the bill containing these amendments receive Royal Assent.

(a) Income Tax Act

**Clause 1**

**Income from Business or Property - Inclusions**

ITA  
12

Section 12 of the *Income Tax Act* (the "Act") provides for the inclusion of various amounts in computing the income of a taxpayer for a taxation year from a business or property.

**Subclause 1(1)**

ITA  
12(1)(c)

Paragraph 12(1)(c) of the Act requires that any interest received or receivable by a taxpayer in a taxation year be included in computing the taxpayer's income for the year. This paragraph is amended as a consequence of the introduction of new subsection 12(5) of the Act. New subsection 12(5) provides that paragraph 12(1)(c) and subsections 12(3) and (4) do not apply to require the inclusion in income of interest on certain impaired loans. New paragraph 12(1)(c) of the Act, which will be subject to subsection 12(3) and new subsection 12(5) of the Act, applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those earlier years.

**Subclause 1(2)**

ITA  
12(3)

Subsection 12(3) of the Act provides that, notwithstanding paragraph 12(1)(c), corporations, partnerships and certain trusts must use the accrual method for computing interest income in respect of certain debt obligations. This subsection is amended as a consequence of the introduction of proposed new subsection 12(5) of the Act. New subsection 12(5) provides that paragraph 12(1)(c) and subsections 12(3) and (4) do not apply to require the inclusion in income of interest on certain impaired loans. New subsection 12(3) of the Act,

which will be subject to new subsection 12(5) of the Act, applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those earlier years.

### **Subclause 1(3)**

ITA  
12(4)

Subsection 12(4) of the Act requires that a taxpayer (other than one to which subsection 12(3) of the Act applies) who holds an interest in an investment contract on the anniversary day of the contract to include in income for the taxation year that includes that day an amount as interest in respect of the contract. This subsection is amended as a consequence of the introduction of new subsection 12(5) of the Act. Subsection 12(4) of the Act will be subject to new subsection 12(5) of the Act. Subsection 12(5) provides that paragraph 12(1)(c) and subsections 12(3) and (4) do not apply to require the inclusion in income of interest on certain impaired loans. New subsection 12(4) of the Act applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those earlier years.

ITA  
12(5)

New subsection 12(5) of the Act provides that new paragraph 12(1)(c) and new subsections 12(3) and (4) of the Act do not apply to a taxpayer in respect of a debt obligation for that portion of a taxpayer's taxation year in which the obligation is impaired and an amount in respect thereof is deductible by the taxpayer under new subparagraph 20(1)(l)(ii) of the Act for the year. Interest is therefore not to be included in a taxpayer's income under new paragraph 12(1)(c) and new subsections 12(3) and (4) for that portion of the taxation year in which the debt obligation is impaired. This is consistent with the new accounting rules which provide that recognition of interest income in accordance with the terms of the original debt obligation ceases on the impairment of the obligation. New subsection 12(5) of the Act applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those earlier years.



**Clause 2**

ITA  
16

Section 16 of the Act deals with the treatment of blended payments which are partly of a capital nature and partly of an interest nature.

**Subclause 2(1)**

ITA  
16(6)

Subsection 16(6) of the Act sets out the tax treatment of the index adjustment on indexed debt obligations both for the holders and issuers of such obligations. This subsection is amended as a consequence of the introduction of new subsection 16(7) of the Act. New subsection 16(6) of the Act, which will be subject to new subsection 16(7) of the Act, applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those years.

**Subclause 2(2)**

ITA  
16(7)

New subsection 16(7) of the Act provides that paragraph 16(6)(a) of the Act does not apply to a taxpayer in respect of an indexed debt obligation for that portion of a taxation year in which the obligation of a taxpayer is impaired if an amount in respect thereof is deductible under subparagraph 20(1)(l)(ii) of the Act by the taxpayer for the year. Interest is therefore not to be included in the income of the taxpayer under subsection 16(6) for that portion of the taxation year in which the indexed debt obligation is impaired. This is consistent with the new accounting rules which provide that recognition of interest income in accordance with the terms of the original debt obligation ceases on the impairment of the obligation. New subsection 16(7) of the Act applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those years.

### Clause 3

ITA  
20

Section 20 of the Act provides rules relating to the deductibility of certain outlays, expenses and other amounts in computing a taxpayer's income.

### Subclauses 3(1) to (5)

ITA  
20(1)(l)

Paragraph 20(1)(l) of the Act permits any taxpayer to claim a reserve in respect of doubtful debts and a taxpayer who is an insurer or whose ordinary business includes the lending of money to claim a reserve in respect of loans and lending assets. A taxpayer whose ordinary business does not include the lending of money but does include the purchasing of debt obligations issued by arm's length persons is unable to claim a doubtful debt reserve. Instead such a taxpayer can use the inventory accounting rules to obtain a current deduction in respect of a debt obligation that has become doubtful and fallen in value.

The maximum reserve a taxpayer can claim under existing paragraph 20(1)(l) in respect of a loan or lending asset is equal to the sum of two amounts. The first amount is a prescribed reserve amount under clause 20(1)(l)(ii)(A) in respect of certain loans and lending assets and the second amount is the amount determined under clause 20(1)(l)(ii)(B) in respect of other doubtful loans and lending assets. The amount under 20(1)(l)(ii)(B) is the lesser of two amounts one of which is the reserve reported in the taxpayer's financial statements. For this purpose, the financial statement reserve is increased by the amount of interest included under subsection 12(3) of the Act in the taxpayer's income for tax purposes to the extent that the interest has reduced the financial statement reserve.

In June 1996, two amendments to paragraph 20(1)(l) of the Act were proposed. They were included in former Bill C-69.

The first amendment extends the application of the paragraph to taxpayers whose ordinary business is the purchasing of debt. Under the new mark-to-market rules, a taxpayer is a financial institution if the taxpayer's ordinary business is the purchasing of debt obligations. As a financial institution, the taxpayer is deemed not to hold as a property in inventory any debt obligation that is a specified debt obligation. To replace an affected taxpayer's lost inventory accounting deduction the amendment to paragraph 20(1)(l) broadens

the paragraph's application to provide such taxpayer's with a current deduction in respect of specified debt obligations that have become doubtful and fallen in value. This amendment applies to taxation years that end after February 22, 1994.

The second amendment is to sub-subclause 20(1)(l)(ii)(B)(II)2. This provision specifies the amount to be added to the financial statement reserve and is amended so that it also applies with respect to amounts included in a taxpayer's income under paragraph 142.3(1)(a). This amendment is consequential on the introduction of the new rules for debt obligations held by financial institutions. It applies to taxation years that end after February 22, 1994.

The following proposed amendments to paragraph 20(1)(l) of the Act reflect the 1995 accounting changes announced by the Canadian Institute of Chartered Accountants, and adopted by the Superintendent of Financial Institutions, in dealing with the recognition and measurement of impaired loans. These changes are effective for taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have proposed new paragraph 20(1)(l) apply to those years. If the taxpayer so elects, the election must be filed with Revenue Canada by the end of the third month after the month in which these amendments to paragraph 20(1)(l) become law.

Subparagraph 20(1)(l)(i) of the Act provides that a taxpayer may deduct a reasonable amount as a reserve in respect of doubtful debts that have been included in income for the year or a previous taxation year. This subparagraph is amended to exclude from doubtful debts those debts to which subparagraph 20(1)(l)(ii) applies.

New subparagraph 20(1)(l)(ii) of the Act provides that the maximum reserve a financial institution or a taxpayer whose ordinary business includes the lending of money may claim in a year is the total of the amounts in clauses (C) and (D) of that paragraph.

The amount determined under new clause 20(1)(l)(ii)(C) is the percentage (not exceeding 100%) that the taxpayer may claim of the prescribed reserve amount set out in section 8000 of the Income Tax Regulations. The reserve described in paragraph 8000(a) of the Regulations applies in respect of a loan to a designated country. A designated country is determined by the Superintendent of Financial Institutions and is set out in the Guidelines issued by the Office of the Superintendent. After October 1995, the Superintendent ceased to designate any new countries. Consequently, paragraph 8000(a) will now be relevant only in respect of loans made before November 1995 to countries designated before that time. The reserve described in paragraph 8000(b) of the Regulations applies in respect of loans that

can be grouped according to type, such as, credit card debt and consumer mortgages, and in respect of which a reserve reduction factor can be applied. The amortized cost of the loans is multiplied by the reserve reduction factor which is referred to as the "historical loss experience". Section 8004 of the Regulations defines "historical loss experience". Paragraph 8000(b) and section 8004 of the Regulations are proposed to be repealed effective for taxation years that end after September 1997, and also for taxation years that end after 1995 and before October 1997 where the taxpayer elects to have new paragraph 20(1)(l) of the Act apply to those years. The impaired loans previously subject to the "historical loss experience" calculation will now be included with all other loans in the reserve amount determined under clause 20(1)(l)(ii)(D) of the Act.

The amount determined under new clause 20(1)(l)(ii)(D) of the Act is the reserve determined for impaired loans, lending assets or specified debt obligations (the "loans") of the taxpayer for a taxation year. Loans exclude direct financing leases as set out in new subparagraph 6209(b)(iii) and new section 9004 of the Regulations. Loans also exclude securities prescribed by new subparagraphs 6209(b)(i) and (ii) of the Regulations released in June 1995. The amount determined under new clause (D) is the specified percentage of the lesser of the amount determined under new subclauses (I) and (II). Specified percentage is a new term which is defined in new subsection 20(2.4) of the Act. The specified percentage for a taxation year for the purposes of clause (D) is the lesser of 100% and the percentage of the prescribed reserve amount of the taxpayer for the year claimed by the taxpayer under clause (C) for the year. In other words, the taxpayer will be required to claim the same percentage under clause (C) and (D) for a particular taxation year except in the case in which the taxpayer does not have a prescribed reserve amount for that year.

New subclause 20(1)(l)(ii)(D)(I) of the Act provides that the reserve amount must be a reasonable amount based on the amortized cost of the loans to the taxpayer at the end of a taxation year. This provision is amended to clarify that the reserve so determined cannot include a sectoral reserve. "Sectoral reserve" is a new term which is defined in new subsection 20(2.3) of the Act.

New subclause 20(1)(l)(ii)(D)(II) of the Act provides that the amount determined thereunder is to be determined by the formula  $0.9M-N$ .  $M$  is the reserve for the loans for the year determined in accordance with generally accepted accounting principles.  $N$  is the total of the specified reserve adjustment for the loans for the year and all previous taxation years which is defined in new subsection 20(30) of the Act. This amendment also clarifies that for tax purposes the reserve cannot include any portion of a sectoral reserve as is defined in new subsection 20(2.3) of the Act.



**Subclause 3(2)**

ITA

20(1)(1.1)

Paragraph 20(1)(1.1) of the Act provides a deduction for a reserve in respect of credit risk losses under guarantees of a taxpayer that are expected to arise after the end of a year. The deduction is the amount of the reserve reported in the taxpayer's financial statement multiplied by one minus the "prescribed recovery rate". The prescribed recovery rate is set out in section 8001 of the Income Tax Regulations. Section 8001 is repealed and paragraph 20(1)(1.1) is amended to refer to this percentage rather than the prescribed recovery rate. New paragraph 20(1)(1.1) of the Act applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(1) of the Act apply to those years.

**Subclause 3(3)**

ITA

20(2.3) and (2.4)

New subsection 20(2.3) of the Act sets out the meaning of the term "sectoral reserve" for the purpose of new clause 20(1)(1)(ii)(D) of the Act. A sectoral reserve is a reserve in respect of properties that are impaired loans, lending assets or specified debt obligations that is determined on an identifiable sector basis, such as, a geographic or industrial sector basis rather than on a property-by-property basis. This is relevant for the purposes of determining the amount of the reserve deduction under new paragraph 20(1)(1) of the Act. This new definition applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(1) of the Act apply to those years.

New subsection 20(2.4) of the Act sets out the meaning of the term "specified percentage" for the purpose of new clause 20(1)(1)(ii)(D) of the Act. The specified percentage for a taxation year is the lesser of 100% and the percentage of the prescribed reserve amount of the taxpayer for the year claimed by the taxpayer under new clause 20(1)(1)(ii)(C) for the year. In other words, the taxpayer will be required to claim the same percentage under clause (C) and (D) for a particular taxation year except in the case where the taxpayer does not have a prescribed reserve amount for that year. This new definition applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997.



where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those years.

### **Subclause 3(4)**

ITA  
20(30)

New subsection 20(30) of the Act provides for the calculation of a taxpayer's "specified reserve adjustment" in respect of a loan for the purposes of the description of *N* in subclause 20(1)(l)(ii)(D)(II) of the Act. This adjustment is made on a loan-by-loan basis and is 10% of the interest income reported on the impaired loan for the year or reflected in the charge or credit for loan impairment. The specified reserve adjustment in respect of a loan for a year is the amount determined by the formula  $0.1(A \times B \times C / 365)$ . *A* is the carrying amount of the loan for the year determined in accordance with generally accepted accounting principles. *B* is the effective rate of interest on the loan for that year determined in accordance with generally accepted accounting principles. *C* is the number of days in the year on which the loan was impaired. New subsection 20(30) of the Act applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) apply to those years.

### **Clause 4**

ITA  
79.1

Section 79.1 of the Act sets out the income tax rules that apply where property of a person is acquired by someone else on the failure of the person to honour a debt.

### **Subclause 4(1)**

ITA  
79.1(8)

Subsection 79.1(8) of the Act prohibits any deduction by a creditor in respect of the principal amount of a debtor's debt on account of bad or doubtful debts where property was acquired by the creditor in respect of the debt. Subsection 79.1(8) of the Act is amended as a consequence of the introduction of new paragraph 20(1)(l) of the Act to refer to uncollectible debts and impaired debts. New subsection 79.1(8) of the Act applies to taxation years that end after

September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have new paragraph 20(1)(l) of the Act apply to those years.

## **Clause 5**

ITA  
142.3

Section 142.3 of the Act sets out rules dealing with specified debt obligations and the amounts to be included and deducted in respect thereof in computing income of a financial institution for a taxation year.

### **Subclause 5(1)**

ITA  
142.3(1)

Subsection 142.3(1) of the Act provides that the amounts included or deducted in respect of a specified debt obligation in computing the income of a financial institution are to be determined in accordance with rules set out in the Income Tax Regulations. This subsection is amended to refer to proposed new subsection 142.3(4) of the Act and is applicable to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have new paragraph 20(1)(l) of the Act to apply to those years.

### **Subclause 5(2)**

ITA  
142.3(4)

New subsection 142.3(4) of the Act provides that subsection 142.3(1) of the Act does not apply to a taxpayer in respect of a specified debt obligation for that part of a taxpayer's taxation year in which the obligation is impaired and an amount in respect thereof is deductible under new subparagraph 20(1)(l)(ii) of the Act by the taxpayer for the year. Therefore no amount will be included in the income of the taxpayer in respect of the obligation under 142.3(1) for the part of the taxation year in which the obligation is impaired. This is consistent with the new accounting rules which provide that recognition of interest income in accordance with the terms of the original debt obligation ceases on the impairment of the obligation. New subsection 142.3(4) of the Act applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and

before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those years.

## **Clause 6**

ITA  
248

Section 248 of the Act defines a number of terms that apply for the purposes of the Act and sets out various rules relating to the interpretation and application of various provisions of the Act.

### **Subclause 6(1)**

ITA  
248(1)

"lending asset"

A lending asset is a bond, debenture, mortgage, note, agreement of sale or any other indebtedness or a prescribed share but does not include a prescribed property. Section 6209 of the Income Tax Regulations sets out the shares and the properties that are prescribed for the purpose of this definition. The definition of lending asset is amended to refer to prescribed property rather than prescribed security. New subparagraph 6209(b)(iii) of the Regulations provides that certain leases will be prescribed property. The new definition of lending asset applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those years.

### (b) Income Tax Regulations

## **Clause 1**

### **Section 6209**

Section 6209 of the Regulations prescribes certain shares and other securities for the purpose of the definition of "lending asset" in subsection 248(1) of the Act. Securities prescribed by paragraph 6209(b) are considered not to be lending assets. The definition "lending asset" in subsection 248(1) is proposed to be amended to refer to prescribed property rather than prescribed security. Paragraph 6209(b) is therefore amended to refer to prescribed property and also to add new subparagraph (iii). New subparagraph (iii) provides that a direct financing lease or any other

financing arrangement that in substance is not unlike a loan is a prescribed property if the taxpayer may deduct an amount under paragraph 20(1)(a) of the Act in respect of the property that is the subject of the lease or arrangement. Because such loans are considered not to be lending assets, they are therefore ineligible for a reserve deduction under paragraph 20(1)(l) of the Act. The amendments to paragraph 6209(b) of the Regulations apply to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those years.

## **Clauses 2, 3, 4, 5, 6 and 7**

### **Section 8000**

Section 8000 of the Regulations sets out rules for determining, amongst other things, "historical loss experience", the prescribed reserve amount and the prescribed recovery rate for the purposes of the reserve deduction under subparagraph 20(1)(l)(ii) of the Act. The prescribed reserve amount includes the method for calculating the reserve for doubtful loans and lending assets in respect of exposure to certain highly indebted countries (designated countries).

Paragraph 8000(a) provides the rules for determining the reserve in respect of loans to a designated country. Countries are designated by the Office of the Superintendent of Financial Institutions and are set out in the Guidelines issued by that Office. After October 1995, the Superintendent will not designate any new countries and will exempt any new loan exposure to countries already designated.

Consequently, paragraph 8000(a) will be relevant only in respect of loans made before November 1995 to countries designated before that time. Paragraph 8000(b) of the Regulations provides rules for determining reserves in respect of classes of loans that are determined by reference to the length of time interest and principal payments are in arrears.

Section 8000, paragraphs 8000(a.1) and 8002(b), sections 8006 and 8007

### *Mexican Brady Bonds*

Effective July 1992 Mexico ceased to be listed as a designated country by the Superintendent of Financial Institutions and, as a result, banks are no longer able to claim a prescribed reserve amount, as determined under existing section 8000 of the Regulations in respect of their Mexican loans and securities. The government undertook to propose amendments to the income tax provisions which

would continue to treat Mexico as a designated country in respect of certain loans or lending assets. These loans and lending assets are commonly referred to as the Mexican Brady Par and Discount Bonds due in 2019 which were substituted for Mexican loans and securities previously covered by the prescribed reserve rules in section 8000 of the Regulations.

The amendment to section 8000 of the Regulations is consequential on the introduction of new clause 20(1)(l)(ii)(C) of the Act which replaces clause 20(1)(l)(ii)(A). New paragraph 8000(a.1) of the Regulations will permit a bank to claim a reserve in respect of its Mexican bonds described in the new definition "specified loan" in section 8006 of the Regulations. This reserve is equal to the reserve previously available under subparagraph 8000(a)(ii) of the Regulations in respect of the loans that the Mexican bonds replaced.

The amendments to section 8002 of the Regulations are strictly consequential on the introduction of new paragraph 8000(a.1) of the Regulations which allows for a reserve in respect of Mexican bonds described in the new definition "specified loan" in section 8006 of the Regulations. A specified loan means a United Mexican States Collateralized Par Bond due in 2019 or a United Mexican States Collateralized Discount Bond due 2019.

New section 8007 of the Regulations is also consequential on the introduction of new paragraph 8000(a.1) of the Regulations. New section 8007 ensures that a paragraph 8000(b) reserve does not apply to a bank in respect of a specified loan to which new paragraph 8000(a.1) applies. Paragraph 8000(b) of the Regulations applies in respect of the reserve calculation for loans that can be grouped according to type, such as, credit card debt and consumer mortgages, and in respect of which a reserve reduction factor can be applied.

New paragraphs 8000(a.1) and 8002(b) and sections 8006 and 8007 of the Regulations are effective for the 1997 and subsequent taxation years and to taxation years that end after 1991 and before 1997 where the taxpayer makes an election to have new paragraph 8000(a.1) apply to those years. Where the taxpayer so elects, the election must be filed with the Minister of National Revenue by the end of the third month after the month in which paragraph 8000(a.1) is published in the *Canada Gazette* Part II.

Paragraph 8000(b) and sections 8001 and 8004

Clause 20(1)(l)(ii)(A) of the Act refers to the prescribed reserve amount for a taxpayer for a year. This amount is determined as the aggregate of the reserve amounts determined under paragraphs 8000(a) and (b) of the Regulations. The reserve under paragraph



8000(b) applies in respect of loans that can be grouped according to type, such as, credit card debt and consumer mortgages and in respect of which can be applied a "historical loss experience" factor. Section 8004 of the Regulations sets out the meaning of "historical loss experience". Section 8001 sets out the prescribed recovery rate for the purposes of subclause 20(1)(l)(ii)(B)(II) and subparagraph 20(1)(l.1)(ii) of the Act. The reference to prescribed recovery rate is no longer relevant to that subclause and subparagraph. Paragraph 8000(b) and sections 8001 and 8004 of the Regulations are repealed effective for taxation years that end after September 1997 and to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have new paragraph 20(1)(l) of the Act apply to those years. The impaired loans previously subject to the "historical loss experience" calculation will now be included with all other loans in the reserve amount determined under new clause 20(1)(l)(ii)(D) of the Act.

## **Clause 8**

### **Part XC**

Part XC of the Regulations contain provisions relating to the tax treatment of securities held by financial institutions.

### **Section 9004**

Part XC of the Regulations is amended to add new section 9004. Subsection 142.2(1) of the Act defines a number of terms that apply for the purposes of sections 142.2 to 142.6 of the Act. One such term is "specified debt obligation" which includes, amongst other things, loans and bonds and excludes, amongst other things, a prescribed property. New section 9004 of the Regulations provides that for the purpose of this definition a prescribed property is a direct financing lease or other financing arrangement that is in substance not unlike a loan where the taxpayer may deduct an amount under paragraph 20(1)(a) of the Act in respect of the property that is the subject of the lease. Such prescribed properties do not qualify as specified debt obligations; consequently when such loans are impaired they do not qualify for a reserve deduction under paragraph 20(1)(l) of the Act. New section 9004 of the Regulations applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those years.

## Clause 9

### Part XCI

Part XCI of the Regulations contains rules for determining the amounts that a financial institution is required to include or deduct each year in respect of a specified debt obligation in computing its income.

### Section 9103

Subsection 9103(2) provides that accrued returns and accrual adjustments are to be determined in respect of a specified debt obligation without any reduction for the possible or actual failure of the debtor to make any payments under the obligation.

Subsection 9103(2) is repealed as a consequence of the introduction of new subsection 142.3(4) of the *Income Tax Act*. The repeal of subsection 9103(2) applies to taxation years that end after September 1997, and also to taxation years that end after 1995 and before October 1997 where the taxpayer elects to have the reserve provisions in new paragraph 20(1)(l) of the Act apply to those years.











